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No. 1

General Introduction and Rules Formerly Adopted

GENERAL INTRODUCTION

IN PRESENTING its first statements of the results of studies of accounting questions, it seems desirable that the committee indicate the standpoint from which it has approached the subject. Its present and future pronouncements should be read in the light of these remarks.

Accounting and the Social System

The committee regards corporation accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of interested parties.

The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet such changes as they occur. In the last forty years the outstanding change in the working of the corporate system has been an increasing use of it for the purpose of converting into liquid and readily transferable form the ownership of large, complex, and more or less permanent business enterprises. This development brought in its train certain uses of the processes of law and accounting, which have led to the creation of new controls, revisions of the law, and a reconsideration of accounting procedure.

Accounting Information for Transitory Owners of Securities

As a result of this development in the field of accounting, problems have come to be considered more from the standpoint of the current buyer or seller in the market of an interest in the enterprise than from the standpoint of a continuing owner. The significance of this change is perhaps not yet fully appreciated, and whether or not the rapid exchange of owners is beneficial to society is a large and important question which society itself should carefully consider; but as long as the practice exists accounting must have due regard for it.

One manifestation of it has been a demand for a larger degree of uniformity in accounting, although it may be pointed out that the change of emphasis itself is bound to lead to the adoption of new accounting procedures, so that for a time diversity of practice is likely to be increased as new practices are adopted before old ones have become completely discarded. It is of interest to point out that "uniformity" has usually connoted a similar treatment of the same item occurring in many cases, in which sense it runs the risk of concealing important differences between the cases. Another sense of the word would require that different authorities, working independently on the same case, should reach the same conclusions. This at any rate is an ideal which all will agree to strive for, and perhaps is more readily attainable.

Other phases have been increased recognition of the significance of the income statement, with a resulting increase in the importance attached to conservatism in the statement of income, and a tendency to restrict narrowly charges to earned surplus. The result of this emphasis upon the income statement is a tendency to regard the balance-sheet as the connecting link between successive income statements and as the vehicle for the distribution of charges and credits between them. Important as this concept is, however, it should not obscure the fact that the balance-sheet has significant uses of its own.

Accounting for "Investment Trusts"

The accounting problems of investment trusts, which for this purpose include all corporations, the business of which consists of owning or trading in the securities of other corporations for purposes other than control, are so special that the committee will, at the appropriate time, issue a statement devoted to them. In the meantime the general pronouncements of the committee should not be regarded as necessarily applicable to investment trusts.

Committee Votes as to Adoption of Pronouncements

The committee regards the representative character and general acceptability of its pronouncements as of the highest importance, and to that end has adopted certain rules for its own procedure.

By unanimous vote it was resolved that:

a. Any opinion before issue shall be submitted in final form to all members of the committee either at a meeting or by mail.

b. No such opinion shall be issued unless it has first received the approval of two-thirds of the entire committee.
c. Any member of the committee dissenting from an opinion issued under the preceding rule will be entitled to have the fact of his dissent recorded in the document in which the opinion is presented.

Pronouncements Not Retroactive

It was unanimously resolved that:

No pronouncement issued by the committee is intended to have a retroactive effect unless it contains a statement of such intention. Thus a pronouncement will ordinarily have no application to any transaction arising prior to its publication, nor to transactions uncompleted at the time of publication. But, while the committee considers it inexpedient to make its general statements retroactive, it does not wish to discourage the revision of past accounts in an individual case if the accountants think it desirable in the circumstances.

Pronouncements Not Applicable to Immaterial Items

The committee contemplates that its pronouncements will have application only to items large enough to be material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest.

Exceptions to General Pronouncements

The committee recognizes that its general rules may be subject to exception and that in extraordinary cases truthful presentation and justice to all parties at interest may require exceptional treatment. But the burden of proof is upon the accountant clearly to bring out the exceptional procedure and the circumstances which render it necessary.

The Company and Its Auditors

At the base of all committee pronouncements is the further understanding that the accounts of a company are primarily the responsibility of its officers. The responsibility of the auditor is to express his opinion as to the correctness of the accounts and to make qualification to the extent that he considers it necessary to explain, to amplify, to disagree, or to disapprove. While these pronouncements will be read by public accountants whose problem is to decide what they may properly report, the prior application of the rules to those who must prepare the accounts is also included in the committee's considerations.

Other Pronouncements Consulted

The committee has, in the course of its study, given careful consideration to prior pronouncements on the several topics, and will continue to do so in all subjects taken up. In particular, weight has been attached to the accounting opinions of the chief accountant of the Securities and Exchange Commission.

Rules Formerly Adopted

In order that the record may be complete, the committee reissues herewith the following rules:

1. The six rules adopted by the membership of the Institute in 1934, the first five of which had been recommended in 1933 to the New York Stock Exchange by the Institute's committee on coöperation with stock exchanges; these are the only rules so far accepted by the Institute as a whole.
2. The report of the committee on accounting procedure to the executive committee in 1938, dealing with profits or losses on treasury stock.

Statements Now Issued

The committee now submits two new statements, entitled respectively:

1. "Unamortized Discount and Redemption Premium on Bonds Refunded."
2. "Quasi-Reorganization, or Corporate Readjustment."

In the first of these statements the committee saw its opportunity to add to its opinion or findings a memorandum of the considerations which have influenced it in reaching its conclusions, making this statement of greater length than will as a rule be necessary in the future. This practice will be followed whenever the controversial character of the subject seems to require it.

Topics for Future Consideration—Suggestions Invited

The committee renews its invitation to all members of the Institute to submit questions upon which they would like to have pronouncements made. In formulating its program the committee has in mind not only the relative importance, but also the timeliness of the several topics. It therefore welcomes any suggestion from members arising out of their current problems.

It may be of assistance to members for the committee to state that the following matters are already receiving attention:

1. A more exact determination of the basis of inventory valuation.
2. Definition of "cost" of fixed assets under varying conditions as to payment or consideration for them.
3. Should accounting recognize a classification of losses other than revenue losses (the so-called capital losses)? If so, what are the distinguishing characteristics of the classification, having regard to the nature of surplus, and of its subdivisions?
4. The possibility of combining the income statement with the statement of surplus, or alternatives to emphasize their related character.
5. An apparent trend toward viewing the annual corporation report to stockholders as being in the nature of a prospectus to investors.
6. The accounting treatment: (1) of options issued to officers and employees of a corporation for services rendered or to be rendered, and (2) of capital stock issued or issuable under these options.
7. Depreciation on appreciation.
8. Comparative statements.
9. Accounting for the purchase and retirement of bonds other than through refunding operations.
10. The proper recording of capital-stock dividends in the books of the issuing company, and of the recipient.
11. The treatment of voluntary payments made by corporations under pension plans.
12. Accounting for cash in foreign banks.

Expressions of opinion which members may offer on any of these topics will be welcome.

RULES FORMERLY ADOPTED

BELOW are printed the rules already adopted (I) by the membership of the American Institute of Accountants, or (II) by its committee on accounting procedure:

I

* "On motion duly seconded the report of the special committee on development of accounting principles, which had been distributed to members of council prior to the meeting, was accepted, and it was ordered that the report be published in the *Bulletin* of the Institute.

* *Yearbook,* American Institute of Accountants, 1934, pp. 196–7.

The motion embodied approval of the following rules or principles which the committee had recommended that the Institute formally adopt:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation."

II

"Profits or Losses on Treasury Stock *

"The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:

To the Executive Committee,
American Institute of Accountants:

This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute's special committee on coöperation with stock exchanges.

As a result of discussions which then took place, the special committee on coöperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:

'Should the difference between the purchase and resale prices of a corporation's own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?'

The opinion of the special committee on coöperation with stock exchanges reads in part as follows:

'Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.'

This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to

* *The Journal of Accountancy*, vol. LXV, pp. 417–18.

taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.

The special committee on coöperation with stock exchanges continued and concluded its report with the following statement:

'Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account).'

This committee agrees with the special committee on coöperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.

This committee recommends that the views expressed be circulated for the information of members of the Institute."